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ARTICLES

AN ANNOTATED CHECKLIST FOR THE FEDERAL INTRASTATE EXEMPTION FROM REGISTRATION OF SECURITIES

Hugh V. Schaefer*

INTRODUCTION

Section 3(a)(11) of the Securities Act of 1933 provides for treatment as an exempt security:

Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within such State or Territory.¹

In the initial scheme of Congress to regulate the securities industry as envisioned in its legislation of the early thirties, the exemption from registration afforded by section 3(a)(11) of the Securities Act of 1933² was deemed advisable because it was not believed to be a matter of federal concern.³ Offerings of a purely local character, limited to a small number of offerees with relatively insignificant amounts of funds involved, were felt to be better left to local regulation since federal regulation might well be impossible if the jurisdictional facilities were never employed in connection with the offerings.⁴

In recent years, utilization of the exemption appears to be deviating from its central purpose. With careful planning, it is not entirely impossible for the resourceful entrepreneur of today to use the exemption as a means to avoid federal regulation of what is essentially a substantial offering. As long as the rather strict and sometimes arbitrary requirements of the exemption are met, it may be utilized to assist the federally unregistered disposition of securities through the services of underwriters and broker-dealers.

This shift in application of the exemption was first noticed by the SEC Special Study of the Securities Markets.⁵ The Special Study indicated that the practice should be cause for concern and the SEC should take a greater role in regulation under the exemption, especially where an offering might

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¹Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(11) (1970). [hereinafter cited as "Sec. Act"].

²*Id.*

³Op. Gen. Counsel, Sec. Act. Rel. 1459 (1937).

⁴Bloomenthal, *The Federal Securities Act Intra-State Exemption—Fact or Fiction?*, 15 Wyo. L.J. 121 (1960).

⁵REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION H. R. Doc. No. 95 Pt. 1, 88th Cong., 1st Sess. 570-75. (1963).

not be essentially local in character.⁶ However, the Special Study's proposal of requiring advance notification to the SEC of the intended reliance on the exemption has never been adopted. The matter has also been cause for concern in the Congress, but no legislation has been enacted to correct the course of the history of the usage of the exemption.⁷ Over the years, the SEC itself has not changed its basic policies in the interpretation of the exemption.⁸ Therefore, regardless of criticism, the exemption continues to be increasingly popular. This article is designed to provide counsel with a checklist of its more important features together with an analytical annotation to each item of the list.

CHECKLIST FOR COMPLIANCE (WITH ANALYSIS)

- I. A. THE ISSUER, IF A PERSON;
MUST BE A RESIDENT OF AND DOING BUSINESS WITHIN THE SAME STATE WHERE THE INTENDED OFFERS AND SALES WILL BE MADE.
- B. THE ISSUER, IF A CORPORATION;
MUST BE ORGANIZED AND DOING BUSINESS WITHIN THE SAME STATE WHERE THE INTENDED OFFERS AND SALES WILL BE MADE.

Discussion and Analysis

If a corporation desires to avail itself of the exemption, it must be a purely local enterprise both from the standpoint of its place of incorporation and place of doing business.⁹ If a person, he must be domiciled and conducting substantially all of his business in the same state where he seeks to make the offers and sales. Domicile is construed by the SEC in the conflict-of-laws sense.¹⁰

Use of the exemption is significantly limited in those states which do not encourage local incorporation because of anti-management statutory policy. Even where a corporation retains all of its business operations in such a state but seeks incorporation in a more liberal or pro-management jurisdiction for what its management deems to be its best interest, the exemption is not available. This facet of the exemption places the sophisticated company on the horns of a dilemma. The corporation which operates its business in a state having a restrictive business corporation act may be forced to give up the opportunity for some quick local financing through the issuance of federally unregistered stock rather than submit to the consequences of local incorporation. In sum, a corporation which incorporates in one jurisdiction and transacts all or substantially all of its business in

⁶*Id.*

⁷*See, infra* notes 17 and 18.

⁸The more important interpretative releases of the SEC involving the applicability of the exemption are: Sec. Act. Rel. 97 part 10 (1933), Sec. Act. Rel. 201 (1934), Sec. Act. Rel. 1459 (1937), Sec. Act. Rel. 4386 (1961), Sec. Act. Rel. 4434 (1961).

⁹*SEC v. Truckee Showboat, Inc.*, 157 F.Supp. 824 (S.D. Cal. 1957).

¹⁰*L. LOSS, SECURITIES REGULATION 598* (Temporary Student Ed., 1961) [hereinafter referred to as *Loss*].

another cannot utilize the exemption at all, since this type of issuer is not considered a wholly local or intrastate business within the meaning of the exemption. This threshold consideration unfortunately is often not considered when it should be, because of its relative obscurity in relation to the other requirements of the exemption which receive far more attention in the literature. However, residence in the state of incorporation of the issuer is not a prerequisite for controlling persons making offerings in conjunction with an intrastate offering of the issuer, as long as the issuer is eligible under the exemption.¹¹

The "doing business" requirement means the corporate offeror or seller of the security must conduct "substantial operational activities" in the state of incorporation.¹² Maintenance locally of business activities which are incidental to comparatively more substantial activities in another state will render the exemption unavailable. The test of doing business rests on an actuality concept as opposed to mere appearances or recitals in corporate documents.¹³

This is not to say that if the issuer transacts business in other states the exemption will be lost. Professor Loss feels that the crucial test that must be met unequivocally is the one requiring a substantial business presence in the state of incorporation.¹⁴ His conclusion is based on the fact that the word "only" used in the language of section 3(a)(11) modifies "offers and sales", and not the words "doing business."¹⁵ Therefore a local corporation with out of state business operations may avail itself of the exemption as long as there is substantial business activity in the state of incorporation. However, Professor Loss is not enamoured with the idea of splitting up a basically single enterprise into subsidiaries incorporated in each state embracing business activities of the offeror so as to come within the exemption.¹⁶

In 1959, the SEC offered a clarifying amendment to section 3(a)(11) of the Act suggesting a change to "conducting his principal business operations."¹⁷ However, a substitute bill deleted this proposal.¹⁸ Does the fact that the issuer may choose to distribute the securities through non-resident underwriters or brokers destroy the exemption? No, so long as the ultimate distribution is to residents of the state of the issuer. Similarly, the residence of a transfer agent is immaterial.¹⁹

¹¹OCH FED. L. REP. ¶2274.

¹²Sec. Act. Rel. 4434 (1961).

¹³H. SOWARDS, *The Intrastate Exemption*, 2 STANDARD & POOR'S REV. SEC. REG. #7 p. 923.

¹⁴Loss, *supra* note 10 at 601.

¹⁵*Id.*

¹⁶*Id.* at 595 n. 130.

¹⁷H. R. 2488, 86th Cong., 1st Sess. (1959) §5.

¹⁸H. R. 5001, S. 1178, 86th Cong., 1st Sess. (1959).

¹⁹Letter ruling, Acting Chief Counsel, Division of Corporation Finance [1952-1956 Transfer Binder] OCH FED. SEC. L. REP. ¶76, 411 (SEC, Sept. 28, 1956).

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All of the issue must be offered and sold in the same state. A single sale to a non-resident will destroy the exemption for the entire issue since each distinct sale is not considered a separate and distinct transaction within the meaning of the exemption.²⁴ In the event of a non-exempt single sale or a non-exempt offer, all purchasers regardless of residence would have standing to sue.²⁵ Also, any sale in violation will nullify the exemption as to any previously valid offer.²⁶ Once the exemption has been lost because of an illegal sale to a non-resident, the issuer may not regain the exemption by stopping non-resident sales and confining itself to resident sales only.²⁷ Presumably, if all sales were intrastate but only one *offer* was made to a non-resident, the exemption would be lost.²⁸ In addition, an offer or sale to a non-resident which, standing alone, might qualify under the non-public offering exemption afforded by section 4(2) of the Act, but when coupled in some way with other offers or sales under the intrastate exemption may nevertheless destroy the availability of the intrastate exemption if any one or more of the following occur:

- a. both offerings constitute a single plan of financing,
- b. both offerings involve issuance of the same class of security,
- c. both offerings are made at or about the same time,
- d. both offerings involve the same consideration,
- e. the proceeds realized from both offerings will be spent for the same general purpose.²⁹

Ordinarily, it is not advisable to combine or integrate an intrastate offering with an offering under another exemption or even as part of an offering that was partially registered under section 5 of the Act.³⁰ With one or two possible exceptions this advice still seems appropriate. Some recent no-action letters issued by the Commission through its Division of Corporate Finance, indicate that the Commission is still critical of integrating offerings under more than one exemption. The Division approved the no-action request in *Clinton Forge-Waynesboro Telephone Co.*³¹ which authorized a secondary offering of a selling shareholder under regulation A shortly after the issuer had offered the same class of securities to some of its employees under the intrastate exemption. In *Lexton-Ancira, Inc.*,³² the use of proceeds raised in a prior intrastate offering to finance the subsequent registration of limited partnership interests to be sold intrastate resulted in a denial of a no-action request. The Division denied clearance since the pur-

²⁴*Shaw v. United States*, 131 F.2d 476, 480 (9th Cir. 1942).

²⁵*Larson et al. v. Tony's Investment, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶93, 324 (M.D. Ala. 1968).

²⁶*Ned J. Bowman Co.*, 39 S.E.C. 879 (1960).

²⁷*Hillsborough Investment Corp. v. SEC*, 276 F.2d 665 (1st Cir. 1960).

²⁸*Loss*, *supra* note 10 at 592.

²⁹*Hunt v. SEC*, 158 F.2d 981 (9th Cir. 1947); *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147 (1935).

³⁰*Ken-Bak Corp.*, (N-A Letter) Sec. Act. § 3(a)(11) Sept. 15, 1971.

³¹*Clinton Forge-Waynesboro Telephone Co.*, (N.A. Letter) Sec. Act. § 3(a)(11) June 16, 1971.

³²*Lexton-Ancira, Inc.*, (N-A Letter) Sec. Act. § 3(a)(11) August 22, 1971.

poses and plans of financing under both offerings were the same. However, in situations involving a prior private placement under section 4(2) of the Act followed by an intrastate offering, possible inconsistencies appear. In *Founders Preferred Life Insurance Co.*³³ and *United Capital Life Insurance Co.*³⁴ there were prior private placements with non-residents followed by intrastate public offerings of the same class of securities. The request was denied in *Founders* but granted in *United*. The significant difference between the two requests appears to be in the fact that the private placements in the *United* request were made to secure new management whereas no such purpose existed in the *Founders* request.

Still other requests in the area of almost simultaneous regulation A and intrastate offerings of limited partnership interests in real estate ventures have been granted because the Division found no integration. It appears that the applicants succeeded by limiting the assets of each limited partnership to property located in the same state where the offers were being made if the offeror was relying on the intrastate exemption, even though the same offeror might be a general partner in another limited partnership in the same state or another state that was making simultaneous offerings under regulation A. The only similarity was a common general partner in all of the limited partnerships involved in the offerings.³⁵ In both letters, the Division indicated that the factor of a common general partner would not alone cause the offerings to be integrated. However, when a corporation sold real estate to its subsidiaries which in turn offered their stock under separate intrastate offerings, the request for a no-action letter was denied apparently because it appeared to be just one corporate family.³⁶ The Division denied this request because contiguous parcels of land were involved in all of the offerings and it constituted integration of the second offering with the first. Even though the offerings in *Boetel & Co.* and *Calprop Corp.*³⁷ under regulation A involved sales by unincorporated organizations dealing with specific real estate under rule 254(d)(5)³⁸ of the Commission and the sales in *Presidential*³⁹ involved corporate enterprises, the contiguity of the land appears to be the real distinguishing factor.

It would seem advisable in light of these rulings on integration to review the more complex offering with the Division of Corporation Finance. The concept of integration is difficult to apply in specific situations. No less an authority than Professor Loss has noted the oscillation of adminis-

³³*Founders Preferred Life Insurance Co.*, (N-A Letter) Sec. Act. § 3(a)(11) June 3, 1971.

³⁴*United Capital Life Insurance Co.*, (N-A Letter) Sec. Act § 3(a)(11) June 9, 1971.

³⁵*Boetel & Co.*, (N-A Letter) Sec. Act § 3(a)(11) Aug. 20, 1971 and *Cal-Prop Corp.*, (N-A Letter) Sec. Act § 3(a)(11) Oct. 1, 1971.

³⁶*Presidential Realty Corp.*, (N-A Letter) Sec. Act § 3(a)(11) Mar. 22, 1971.

³⁷*Boetel & Co.* and *Cal-Prop Corp.*, *supra* note 35.

³⁸Regulation A, SEC rule 254(d)(5).

³⁹*Presidential Realty Corp.*, *supra* note 36.

trative policy under this exemption.⁴⁰ However, some general rules, obvious exceptions notwithstanding, may be posited as initial parameters.

1. Combining an offering to resident promoters upon incorporation simultaneously with an intrastate offering to the public will not integrate the promotional stock with the public offering.⁴¹

2. Unsold allotments of a previously registered issue may be sold through a subsequent intrastate exemption without any taint of integration.⁴² However, the reverse of the foregoing situation would constitute integration and destroy the exemption as far as the prior intrastate exemption is concerned.⁴³

It also seems evident that the overriding test of the availability of the exemption is the residence of the offerees. This assumption leads to a consideration of a paradox between the characterization of the exemption and its actual application. Even though the exemption is referred to as the "intrastate" exemption, there is no restriction on, or loss of, the exemption merely from the fact that transactions in the hopefully exempt offers or sales are conducted in the facilities of interstate commerce or the U. S. mails, as long as the recipient of the offer or sale is a bona fide resident of the same state as the offeror or issuer. In fact, a valid offer or sale may be made in interstate facilities to a bona fide resident of the state who is traveling or temporarily residing out of the state. On the other hand, an offer or sale may never be made to a non-resident even if he is travelling or temporarily residing within the state of the offeror. Sales to residents of one state and to residents of a foreign country are not exempt.⁴⁴ This paradoxical application of the exemption's restrictions has led one commentator to characterize the exemption as a misnomer.⁴⁵ Use of resident nominees or agents for non-residents is clearly impermissible.⁴⁶ Military personnel as offerees are a good example of a non-bona fide resident and are often cited as the classic illustration of this restriction.⁴⁷ However, there is another offeree to be avoided, namely, the non-resident corporation. If the potential corporate offeree is not incorporated in the state where the offer or sale is made then the exemption would not be available. This is true even when the corporate offeree has its principal place of business in the same state as the offeror and is usually considered a resident of that state for other purposes such as federal diversity of citizenship.⁴⁸

⁴⁰Loss, *supra* note 10 at 574.

⁴¹Non-resident promoters involvement in this type of situation will destroy the exemption. *Id.* 594-95. Escrow and impounding requirements are discussed *infra*.

⁴²H. BLOOMENTHAL, SECURITIES LAW 170 (1966).

⁴³Loss, *supra* note 10 at 593.

⁴⁴Alexeff Investment Corporation, (N-A Letter) Sec. Act § 3(a)(11) Feb. 3, 1972.

⁴⁵BLOOMENTHAL, *supra* note 4 at 121.

⁴⁶Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957).

⁴⁷Sec. Act Rel. 4434 (1961).

⁴⁸Loss, *supra* note 10 at 599-600.

An often asked question is: "How long must the bona fide resident offeree hold the security before resale?" Stated another way, what is meant by the phrase "come to rest"?

Unlike the private offering exemption there is no counterpart to rule 144⁴⁹ or other statutory or interpretive guidelines available under the intrastate exemption. The length of the holding period may vary from situation to situation depending on other circumstances which should be discussed.

At the outset, no resales by residents to non-residents should occur during the course of distribution of an issue under an exemption. An earlier release of the Commission clearly indicated this by the statement that upon completion of the ultimate distribution of the issue all of the securities thereunder must be in the hands of bona fide residents of the state of the issuer.⁵⁰ Actually, the resale problem may be approached from two standpoints: first, when may all offerees as a group be free to resell their securities; and, second, are there circumstances when an individual may sell independent of any restrictions on the entire group of offerees? As to the first standpoint, the focus is on completion of the whole issue or "ultimate distribution", while the second focuses on the phrases "come to rest" and "with a view to re-sale." In the case of *Brooklyn Manhattan Transit Corp.*,⁵¹ the Federal Trade Commission found a rebuttable presumption existing under section 3(a)(11) that was analogous to the conclusive presumption of section 4(1) or dealer's exemption that sales of dealers within one year from the first date of the offering are part of the distribution of the issue.⁵² However, 1954 amendments to the Act shortened this presumption under the dealer's exemption to 40 days.⁵³ Professor Loss does not see the SEC analogizing for a shorter period,⁵⁴ particularly in light of *SEC v. Hillsborough Investment Corp.*⁵⁵

It therefore seems that the holding in *Brooklyn Manhattan Transit*⁵⁶ is still the general rule as to when all offerees are usually free to resell. As far as individual resales are concerned, it would seem that an unforeseeable-change-of-circumstances concept might be appropriate, particularly where the offeree took the securities without any present intent to resell to non-residents and his resale is dictated by unforeseen or emergency circumstances. The unforeseeable circumstances would be similar to those necessary before a holder of "Letter Stock" could sell under section 4(2) of the Securities Act of 1933 before the adoption of Rule 144 of the Commission.

⁴⁹SEC rule 144. Sec. Act Rel. 5223 (Jan. 10, 1972).

⁵⁰Sec. Act Rel. 1459 (1937), *supra* note 22 at p. 3-42.

⁵¹1 S.E.C. 147 (1935).

⁵²*Id.* at 162-63.

⁵³Sec. Act., § 4(3), amended by Act of Aug. 10, 1954, ch. 667 Title 1, § 6, 68 Stat. 684.

⁵⁴Loss, *supra* note 10 at 600.

⁵⁵*Perm. inj. granted*, 176 F.Supp.789 (D.N.H. 1959), *aff. without consideration of inj. issue*, 276 F.2 665 (1st Cir. 1960) *passim* resales to non-residents after thirty days enjoined as violative of injunction.

⁵⁶1 S.E.C. 147 (1935).

A legitimate interstate change of residence of the offeree after receipt of and payment for the securities and before ultimate distribution is completed does not destroy the availability of the exemption. However, where the offeree changes residence before the securities are fully paid for, *e.g.*, when the securities are being purchased or financed through installment loans, the exemption may be lost unless the sales agreement is treated in its entirety and the installments are increments of one overall "sale." However, possible frustration of the exemption may occur if each installment is a separate sale. The best detailed treatment of this problem is found in Sowards' *The Federal Securities Act*.⁵⁷

The exemption will be lost if the offerees take the securities with a view towards distribution to non-residents or promptly resell them to non-residents, regardless of whether the resales are effected through non-jurisdictional facilities. The SEC has maintained the position that the shorter the holding period before resale to non-residents the stronger the presumption that the securities have not come to rest in the hands of a bona fide resident. Resales even to resident dealers or brokers create a similar presumption against intrastate investment intent because the securities appear to be available for purchase by non-residents.⁵⁸

The following steps should be taken by the issuer to restrict premature redistributions to non-residents and thereby support the availability of the exemption:

1. The registrar, secretary or transfer agent should be instructed not to allow *any* transfer of the security unless approved by counsel for the issuer. It is not advisable to limit stop transfer orders only to non-resident sales since the possibility of a resale to a resident nominee for a non-resident or to a foreign corporation with a local address may occur and not be detected. The safest course to follow is to scrutinize all transfers.
2. If the securities are evidenced by certificates, a legend should appear "dramatically" on the certificate, in clear and obvious contrast to other printing on the certificate, indicating that the securities are not available for resale to non-residents unless approved by the issuer. Obviously, this is rather easy to accomplish where ownership is evidenced by as formal a document as a corporate security. On the other hand, the legend is often overlooked or ignored when the security is evidenced by something less formal than a stock certificate, such as copies of investment contracts, deeds, assignments, commercial paper, limited partnership agreements, etc. These documents should have a similarly suitable and obvious legend affixed if (in fact) they are muniments of title to a "security." The legend should be in substantially the following form:

⁵⁷SOWARDS, *supra* note 22 at 3-42.

⁵⁸Sec. Act. Rel. 4386 (1961).

The securities represented by this certificate have not been registered with the Securities Exchange Commission but have been sold pursuant to an exemption under section 3(a)(11) of the Securities Act of 1933 and may not be resold, transferred or exchanged to non-residents of the State of until registered or an opinion of counsel to the issuer hereof that registration is not required under such Act.

3. All selling literature, offering circulars, prospectuses, advertising in newspaper or television should indicate that the securities are available only to bona fide residents of the state where the offer is being made.
4. In order for these restrictions, legends, and other warnings to be effective, a document explaining what constitutes holding for investment and resales to non-residents should accompany all sales literature or other communications in connection with the sales effort. This is to avoid any problem with those offerees who would have no idea about the legal significance of a resale to a non-resident. The SEC has particularly frowned on the use of form-type restrictions when the uninformed are involved. The fact that these documents, legends, and caveats are used is no safeguard that the issuer has become immunized from any possible loss of the exemption.⁵⁹ Perhaps the best place to attach the explanatory document described above would be in the order or subscription forms. The legend is particularly helpful where the offeree uses the securities as collateral for a loan and is required by the lender to deposit the securities with him pending repayment of the loan.⁶⁰ Absent such a restriction, the lender could very easily dispose of them in a variety of ways to non-residents in the event of default.

The foregoing steps are only minimal and frequently additional restrictions as the following are advisable under special circumstances:

1. It may be advisable to use contractual provisions restricting any assignment or transfer to non-residents for a stipulated period of time. Usually, the stipulation covers at least a year or 18 months from the date of acquisition.
2. If it is at all possible, avoid any use of time payment contracts or subscriptions. However, if they are used, the offeree should be required to enter into a firm commitment to buy. Any language which gives the purchaser the right to avoid completing payment should be avoided, since the SEC may regard the installment con-

⁵⁹Sec. Act. Rel. 3825 (1957).

⁶⁰Acceptance of restricted or unregistered securities by banks or other institutional lenders as collateral is usually doubtful. See, SEC v. Guild Films Company, Inc., 279 F.2d 485 (2nd Cir. 1960).

tract as merely a series of options to be exercised and each exercise as a separate and distinct sale. However, if installment contracts are used, they should include a provision to the effect that if the offeree relocates in another state before completion of the payments or delivery of the security, then the contract is mutually terminated.⁶¹

3. Some issuers try to keep the offers and sales under the exemption as private as possible and avoid using "door to door" or other types of high pressure sales techniques. The use of soliciting salesmen is often avoided since they may overlook the need for verification of residence. This may be impossible if an underwriting is involved. However, the underwriter is just as leery about losing the exemption as is the issuer and perhaps more so. Most underwriters prefer traditional sales channels, such as reputable and well known brokers.
4. If an underwriting is involved, the contract should contain appropriate assurances that all underwriters, brokers, or dealers will sell only to bona fide residents and that they will independently verify the fact of such residences. As soon as the selling group is formed, the underwriter should obtain representations to this effect from all brokers, dealers and other underwriters, and deliver copies thereof to the issuer.
5. Utilize the no-action letter procedure afforded by the Division of Corporation Finance of the Commission particularly where an integration question appears. Normally, a no-action request in an ordinary intrastate exemption problem doesn't result in any definite answer because the distribution of the securities has not been completed.⁶²

A no-action letter, however, refers only to the position of the SEC and is not a bar or proof against the claims of any purchaser of the security sold without registration that registration should have been accomplished.⁶³

IV. THE EXEMPTION APPLIES ONLY TO THE REGISTRATION REQUIREMENTS, AND DOES NOT RELIEVE THE ISSUER FROM THE ATTENDANT CIVIL AND CRIMINAL LIABILITIES PROVIDED IN THE ACT.

Often, the uninformed make the erroneous assumption that qualifying a security or a transaction as exempt means that the parties involved are no longer subject to the jurisdiction of the Act. An exemption only frees the claimant from the obligations of registration under section 5 of the Act, but never from the remedial provisions of the Act which are afforded those who have been injured by the failure to register, or by fraud, misrepresentation

⁶¹SEC v. American Founders Life Ins. Co. of Denver, CCH FED. SEC. L. REP. ¶90, 861 (D. Colo. 1958).

⁶²Cal-Prop Corp., (N-A Letter) *supra* note 35.

⁶³Sec. Act Rel. 4552 (1962).

or omission of a material fact in connection with the sale of an exempt security or transaction.⁶⁴

While civil and criminal liabilities under the Securities Act of 1933 are a topic unto themselves, at least a cursory explication should be made to illustrate their interplay with the intrastate exemption. The important sections to consider in this context are sections 12(1), 12(2), 17, 20 and 24.⁶⁵ Section 11, which pertains to misstatements or omissions of material facts in a registration statement has no application here.⁶⁶ Sections 12(1) and 12(2) are somewhat related insofar as both sections limit recovery by a buyer against his immediate seller, or someone in a control relationship with the seller, and both have identical remedies to the purchaser. However, the sections are dissimilar as far as the basis for a cause of action under each is concerned.

Section 12(1) gives a remedy to a purchaser of security which was sold to him without registration under section 5 *unless there is an available exemption*. This section renders voidable any sale of a security which should have been, but was not registered. This remedy exists without regard to any written or oral communication made in connection with the sale, no matter how truthful the statements may be. In the context of the intrastate exemption, failure to meet any of the previously enumerated criteria would result in the loss of the availability of the exemption and thus bring section 12(1) into play.

Section 12(2) provides a remedy for any misrepresentation or omission of a material fact in connection with the sale of any security regardless of whether or not the security is registered. This section renders voidable the sale of any security, even a sale which would qualify for an exemption, if misrepresentations or omissions occur.

As far as defenses are concerned, both sections require use of the mails or facilities of interstate commerce in order to invoke jurisdiction under section 5. It is possible that purely face to face transactions might avoid the jurisdictional aspect, but since a legitimate use of the intrastate exemption does not require avoidance of these facilities in the first place, it is a remote defense. However, a sale to a non-resident without use of the jurisdictional facilities, in the opinion of Professor Loss, would deny the buyer a 12(1) remedy unless he could prove that other sales, whether to residents or non-residents, did involve use of the jurisdictional facilities.⁶⁷ Also, the Act's definition of a "sale" is much broader than the definition of the word in other contexts. In *Belhumeur v. Dawson*⁶⁸ the court denied the availability of the exemption because a sale to a non-resident, which only indirectly involved use of mails, was sufficient to vest jurisdiction under

⁶⁴SEC v. American Founders Life Ins. Co. of Denver, 1 S.E.C. 147 (1935).

⁶⁵15 U.S.C. §§ 77e(1), 77e(2), 77(q), 77(t), 77(x) (1970).

⁶⁶15 U.S.C. § 77(k) (1970).

⁶⁷Loss, *supra* note 10 at 593.

⁶⁸*Belhumeur v. Dawson*, 229 F.Supp. 78 (D. Mont. 1964).

the Act. The SEC, however, feels that a sale or offer to a non-resident without use of any jurisdictional facilities does not preclude its power to enjoin further offers or sales under the claim of the exemption.⁶⁹ Assuming the use of jurisdictional facilities and the presence of privity between the purchaser and seller, the only other defenses available under 12(1) would be waiver and estoppel.⁷⁰ Reliance, *scienter*, good faith or causation are not defenses under section 12(1).

Section 14 of the Act prohibits the defense of waiver where it has become the subject of contract or stipulation between the parties.⁷¹

Under section 12(2) the seller has a due diligence defense similar to that under section 11 of the Act as well as the defense that the buyer knew of the untruth or omission complained of before he bought the security.⁷² Estoppel appears to be an additional defense under 12(2) by reason of the broad language of the court in *Straley*.⁷³

Both 12(1) and 12(2) provide a similar remedy of rescission upon tender, together with interest less any income received thereon, if the securities are retained; or damages if the securities are no longer owned at the time of suit, the intended measure of damages being the same recovery as in the case of rescission.⁷⁴

Assuming appropriate allegations of fraud in the securities law sense, a separate cause of action may lie for damages under section 17 of the Act notwithstanding the availability of an exemption under section 3(a)(11). The question of combining section 12 actions with a section 17 action is now under consideration in the case of *Dorfman v. First Boston Corp.*⁷⁵ Criminal actions and injunctions may be initiated under section 24. Attorneys who participate in unlawful sales of unregistered securities and render an opinion in connection therewith may be disqualified from practice before the SEC.⁷⁶ Attorneys may even be subject to direct civil liabilities if the SEC prevails in the recently filed case of *SEC v. National Student Marketing Corp.*⁷⁷ In that case, attorneys are named as defendants in a fraud action for allowing their clients to publish false and misleading information in connection with a merger, without any effort to correct the fraud.

V. QUALIFYING FOR THE INTRASTATE EXEMPTION UNDER THE SECURITIES ACT OF 1933 DOES NOT OBIATE THE NECESSITY FOR OBSERVING STATE "BLUE SKY" REQUIREMENTS.

Another false assumption that is often indulged in as equally as the one in Item IV is that having secured satisfaction as to the availability of the

⁶⁹Op. Gen. Counsel, Sec. Act Rel. 1459 (1937).

⁷⁰*Straley v. Universal Uranium & Milling Corp.*, 289 F.2d 370 (9th Cir. 1961).

⁷¹*Wilko v. Swan*, 346 U.S. 427 (1953).

⁷²*Woodward v. Wright*, 266 F.2d 103, 116 (10th Cir. 1959).

⁷³*Straley*, *supra* note 70.

⁷⁴*Sowards*, *supra* note 22 at p. 9-26.

⁷⁵CCH FED. SEC. L. REP. ¶93, 431 (E.D. Pa. 1971).

⁷⁶*Morris Mac Schwebel*, 40 S.E.C. 347 (1960).

⁷⁷Civ. Action No. 225-72, (D.D.C. Feb. 3, 1972).

intrastate exemption, there need be no concern with local law either as to the availability of an exemption or the necessity to register the offering with the local securities administrator.

A brief discussion of the parameters of state regulation is necessary to dispel this misconception. While this discussion is directed to compliance with the Montana Securities Act,⁷⁸ nevertheless, the discussion should be applicable in those jurisdictions which, like Montana, have adopted the Uniform Securities Act. These jurisdictions require the registration of all securities offered or sold within the state unless an exemption under the local law is available.⁷⁹ As far as registration is concerned, the state policy requiring registration is similar to section 5 of the Securities Act of 1933.⁸⁰ However, there is no substantive similarity between state and federal exemptions.⁸¹ While the Securities Act of Montana is divided into exempt securities and exempt transactions similar to sections 3 and 4 of the Securities Act of 1933, the character and type of securities and transactions exempt under state law are dissimilar to those under federal law. There is no state exemption available simply because a security or transaction is exempt under federal law. It is often difficult to qualify an intrastate exemption for an exemption under local law. Frequently, the exemption that is sought under state law is the exemption afforded by § 15-2014(8).⁸² However, such an exemption is difficult to fashion on top of an intrastate exemption because of certain restrictions therein which would tend to defeat the availability of the intrastate exemption. It might not be completely impossible for an issuer to confine offers to fewer than ten persons during a twelve month period, but those persons must purchase for the purpose of investment which may require a different and possibly longer holding period prior to resale than would be required prior to resale under the intrastate exemption.⁸³ Since § 15-2014(8)(b) prohibits commissions or other remunerations in connection with the offering, underwriter or broker assistance in the offers or sales would be impossible under the exemption.

Unless the registrant is one of those issuers who can qualify under the rather stringent provisions of a registration by notification,⁸⁴ then the intrastate issuer is faced with a full and complete registration by qualification.⁸⁵ Registration by co-ordination is permitted only in connection with

⁷⁸REVISED CODES OF MONTANA, § 15-2001 *et seq.* (1947) [hereinafter cited R.C.M. 1947]. For a thorough discussion of this legislation see: Newton, *A Look at the Montana Securities Act and Its Relation to the Federal Securities Act*, 25 MONT. L. REV. (1964).

⁷⁹R.C.M. 1947, § 15-2007.

⁸⁰15 U.S.C. § 77(e) (1970).

⁸¹R.C.M. 1947, § 15-2013 (Exempt securities) and R.C.M. 1947, § 15-2014 (Exempt transactions).

⁸²R.C.M. 1947 § 15-2014. This is assuming that the issuer's securities are not listed on a national stock exchange which is registered with the SEC. If so, an exemption is available from local registration under R.C.M. 1947, § 15-2013. Also R.C.M. 1947, § 15-2014 exempts transactions by executors, administrators, sheriffs, marshals, receivers, trustees in bankruptcy, guardians or conservators.

⁸³R.C.M. 1947, § 15-2014(8)(a).

⁸⁴R.C.M. 1947, § 15-2008.

⁸⁵R.C. M. 1947, § 15-2010.

a registration under the Securities Act of 1933.⁸⁶ Assuming that the issuer has no objection to registering the offering by qualification, he has no assurance that the offering will be allowed by the State Investment Commissioner. If the offering does not appear to be fair, just, and equitable to the commissioner, he may deny effectiveness to the registration. In Montana, he may simply deny effectiveness if it is in the public interest to do so.⁸⁷ He may also order the impounding of moneys received as well as the escrowing of securities for some period of time when new or promotional shares are involved.⁸⁸ The commissioner may raise or lower this percentage as he deems advisable under the circumstances. This power can very readily put a crimp into an intended quick financing since there may be too much delay in realizing the proceeds from the offering to suit the plans of the issuer. Administrative policies as to promotional shares and impounding agreements may be found in the Montana Investment Commissioner's Rules and Regulations appearing at 25 Mont. L. Rev. 205.

CONCLUSION

The exemption is a curious paradox. While its purpose is to allow state regulation of purely local offerings, nevertheless it is possible for some relatively large local offerings of an issuer's securities which are listed on national exchanges to go unregulated at the local level because of the exemption permitted for such listed securities under, for example, § 15-2013(8) of the Securities Act of Montana.⁸⁹ Also implicit in the rationale for the exemption is the assumption that regulation of a purely local offering may be jurisdictionally impossible if none of the interstate facilities or mails is used. However, the exemption is not lost even if these facilities or the mails are used so long as the offerees are residents of the state involved. A definitional problem contributes to the difficulty of the exemption's application. Although the exemption is classified as an exempt security, it is not the essential nature or type of security *per se* which qualifies for the exemption but the avoidance of the offending transactions.⁹⁰ It would seem more proper to classify the exemption as a transactional exemption rather than as an exempt security. Yet, the exemption is totally unavailable to a corporate issuer who incorporates in one jurisdiction but maintains its principal business activities in the same jurisdiction as its residence. It would seem that this requirement is unduly restrictive when compared to the non-offending interstate aspects.

It would seem that the SEC's policy on this point is behind the times. Even purely local corporations may incorporate in jurisdictions which are foreign to their base of operations. It would seem consonant with the over-

⁸⁶R.C.M. 1947, § 15-2009.

⁸⁷R.C.M. 1947, § 15-2012(1). Other conditions regarding denial of effectiveness of a registration statement are found also in R.C.M. 1947, § 15-2012.

⁸⁸R.C.M. 1947, § 15-2011(2).

⁸⁹R.C.M. 1947, § 15-2013(8).

⁹⁰This inconsistency has been noted in the past. *cf.* H.R. 1838, 73rd Cong. 2d Sess. 40 (1934); *Op. Gen. Counsel*, Sec. Act. Rel. 646 (1936).

all purpose of the exemption that the corporate issuer who maintains no assets or conducts any substantial business activity in the state of its incorporation, should be allowed to offer securities under the exemption in the state of its principal place of business, if all or substantially all of its assets or business are confined there.

In spite of its restrictions, the exemption does offer some advantages over other exemptions.

Unlike the non-public offering under section 4(2) of the Act, sales or offers need not be confined to the sophisticated investor, nor to those persons having access to the data in the hands of the issuer which would otherwise be available only if registration occurred. Also, there is no limit on the number of offerees or purchasers. The buyer of a security under this exemption need not "be able to fend for himself."⁹¹

There is no definite holding period, and once the securities have come to rest, they may be resold even to non-residents and then in unlimited amounts.⁹² There is no "dribble rule" in effect. With these advantages and its paradoxical nature, the exemption is thriving and should continue to receive increasing attention from all segments of the securities industry.

⁹¹SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

⁹²SEC rule 144, Sec. Act. Rel. 5223 (1972).